No. 10188

In the United States Circuit Court of Appeals

For the Ninth Circuit

AMERICAN SURETY COMPANY, a Corporation, and E. L. McDOUGAL, *Appellants*,

vs.

THE BANK OF CALIFORNIA, NATIONAL ASSOCIATION, a Corporation, *Appellee*.

Appellants' Brief

Upon Appeal from the District Court of the United States for the District of Oregon

HONORABLE JAMES J. FEE, District Judge

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JURISDICTION OF THE DISTRICT COURT

While the decision of the District Court was upon the merits, that court holding that it had jurisdiction (Tr. 43), it should be stated that such jurisdiction was at the outset contested by appellee. The jurisdiction of the District Court is based upon 28 U.S.C.A., Sec. 41, Subd. (1) and (16). Plaintiff American Surety Company is a New York corporation and plaintiff E. L. McDougal

is a resident and citizen of Oregon. Defendant is a national banking association. Its home office and principal place of business is in the City of San Francisco, State of California, "with branches at Portland, Multnomah County, Oregon," and other places (Tr. 13-4, 215). 28 U.S.C.A., Sec. 41, Subd. (16), provides that for the purpose of determining diversity of citizenship national banking associations shall "be deemed citizens of the state in which they are respectively located."

A motion to dismiss (Tr. 11-3) filed by defendant included as one of the grounds alleged lack of jurisdiction, the motion stating (Tr. 11) that "defendant may have been, for the purposes of this cause, also a citizen and resident of the State of Oregon. Defendant suggests that the court lacked jurisdiction in that at the time of the institution of this cause Interior Warehouse Company, plaintiff E. L. McDougal, and defendant, and each of them, may have been citizens and residents of the same state."

This motion was denied (Tr. 43, 65), and we submit that the decision of the trial court taking jurisdiction was correct. While neither side could find any decisions directly in point, we believe the following authorities clearly show that jurisdiction exists: *Zollman Banks and Banking,* Section 881, et seq.; *Petri vs. Commercial National Bank,* 142 U. S. 644, 12 S. Ct. 325, 35 L. Ed.

1144; *First National Bank vs. Hozier,* 267 U. S. 276, 45 S. Ct. 261, 69 L. Ed. 609; *New England National Bank vs. Calhoun,* 9 F. (2d) 272; *St. Louis & S. R. R. Co. vs. James,* 161 U. S. 545, 16 S. Ct. 621, 40 L. Ed. 802; *Southern Railway Co. vs. Allison,* 190 U. S. 326, 23 S. Ct. 713, 47 L. Ed. 1078.

The matter in controversy exceeds, exclusive of interest and costs, the sum of $3,000.00.

JURISDICTION OF THE CIRCUIT COURT OF APPEALS

The jurisdiction of the Circuit Court of Appeals to review the judgment of the District Court (Tr. 68) is based upon 28 U.S.C.A., Sec. 225, it being a final decision in the District Court, a direct review of which may not be had in the Supreme Court under 28 U.S. C.A., Sec. 345.

STATEMENT OF THE CASE

This case involves the right of the American Surety Co. and E. L. McDougal, as an assignee of Lloyds of London, to recover from the Bank of California, hereinafter referred to as "the bank." the sum of $6,562.33, which the bank deducted and charged to the funds of the Interior Warehouse Company, its depositor, upon

the bank's payment of checks drawn by said depositor, which checks bore forged indorsements of the payees named thereon.

Between September 1st, 1935, and May 2nd, 1939, the Interior Warehouse Company was a depositor of the bank, with funds on deposit at all times during said period (Tr. 45). During said time it had in its employ one G. L. Crowe, who was a bookkeeper and payroll clerk and who had charge of the payroll of his employer, and in such capacity had charge of the distribution of payroll checks to certain of the employees. He would receive payroll records of superintendents in charge of the employees working at the company's dock and also at the company's country warehouses. It was his duty to have checks prepared for the various persons named in the payrolls and present said checks to the proper officers of his employer who were authorized to sign the checks drawn by the company (Tr. 150, 151, 154). In presenting these checks to the person authorized to sign same, Crowe represented that the persons named in said checks were on the payroll and entitled to be paid the amounts specified in said checks, and at the same time he also presented the payrolls in which the names of the payees appeared as employees of the company and the amounts opposite their names on the payrolls corresponded with the amounts stated on the face of the

checks. The officers who signed said checks intended them as payment to the payees named therein (Tr. 169, 152, 154, 157). When the checks were signed, they were returned to Crowe for the purpose of delivery to the persons named therein as payees.

During the above period, September 1st, 1935, and May 2nd, 1939, Crowe had checks made out to the order of various named persons, some of whom were former employees, some of whom were present employees who had already been paid, and some of whom were non-existent and fictitious persons (Tr. 60, 61, Plaintiff's Exhibit 3, Tr. 221-232). When these checks were signed and given to him for delivery to the persons named therein, all of which had been represented by him to be present employees to whom the company was indebted, he kept the checks, forged the names of the payees named therein and then cashed them (Tr. 169-171, 236, 237). Between said dates, he did this to 126 checks, forging the name of the payee on each one. These checks totalled $6,562.33 (Tr. 61).

Sixty-three (63) of these checks aggregating in amount $3,996.53 represented payments to country employees of the Interior Warehouse Company who were paid by said company by other means (Tr. 60).

Twenty-one (21) of said checks aggregating $812.24 in amount represented payments to fictitious persons who

never were authentic employees of said Interior Warehouse Company (Tr. 60).

Twelve (12) of said checks aggregating $433.58 in amount represented payments to existing persons who previously had been, but no longer were, authentic employees of said Interior Warehouse Company and who had previously been paid by said company for their services (Tr. 60).

Eleven (11) of said checks aggregating $369.59 in amount represented payments to Portland, Oregon, dock employees of said Interior Warehouse Company who previously had been or later were paid by said company by other means (Tr. 61).

The original of nineteen (19) of said checks aggregating $950.39 in amount represented payments to employees of said Interior Warehouse Company, who were paid by said company by other means, were destroyed by Crowe, so as to these nineteen the record does not show where he had them cashed (Tr. 59, 61). Of the remaining one hundred seven (107) he cashed ninety (90) of them at Meier & Frank Co., Inc., a large department store in Portland, eight (8) of them at Lipman Wolfe & Co., another large department store, and the remaining nine (9) by presentation to others. Only one (1) check did he present directly to the Bank of California after indorsing it again by writing his true name (Tr. 46-58).

These one hundred seven (107) checks reached the

defendant bank in the following manner: Fifty-nine (59) were presented to the bank through the Portland Clearing House by the First National Bank, each check bearing the clearing house indorsement; thirty-seven (37) were presented to the bank through the Portland Clearing House by the United States National Bank, each check bearing the clearing house indorsement. These checks also bore prior indorsements subsequent to the forged indorsements of the payees. Nine (9) checks were presented to the Bank of California by Meier & Frank Co., Inc., where they had been cashed, and the two (2) remaining checks of this number were presented to the Bank of California, one by Crowe and one by an individual named Guindon (Tr. 46-58).

The amounts of these various checks bearing the forged indorsements of the payees were charged by the bank to the account of the Interior Warehouse Company. When the forgeries were discovered in May of 1939, the Interior Warehouse Company notified the bank and no further checks with forged indorsements were paid by it (Tr. 106).

The Interior Warehouse Company employed Price Waterhouse & Co., accountants, to audit their books. These accountants audited the books of the company at various times during the time Crowe worked for them and when these checks were drawn (Tr. 137, 142). No

discovery of the forged indorsements was made either by Interior Warehouse Company or the auditors until May, 1939. In the course of an audit during that month an accountant of Price Waterhouse & Co. noticed a coincident fact that a cancelled check which had been returned by the bank, and which check was payable to a laborer in eastern Washington, bore under the indorsement the Portland address of his personal friend. This discovery led to a discovery of all the transactions covering the forged checks. (Tr. 109).

During all of this time the Interior Warehouse Company had a policy of insurance with the plaintiff, American Surety Company of New York, which insured the Interior Warehouse Company against loss it might sustain by reason of fraud, dishonesty, forgery, theft, embezzlement, wrongful abstraction or willful misapplication of any of its employees, including Crowe. This policy of insurance was executed and delivered to Interior Warehouse Company in consideration of a premium paid by it, and not by the employees, to said insurer. The Interior Warehouse Company also had a policy of insurance with the Underwriters at Lloyds of London insuring it for any such loss that it might sustain, which policy was in excess of the limits provided for in the policy of the American Surety Company and for it the Interior Warehouse Company and not the employees paid a

premium directly to the Underwriters. Following the discovery that these checks had been forged and that the bank had deducted the sum of $6,562.33, the American Surety Company paid the Interior Warehouse Company the sum of $1,000.00, the limit of its policy, as and for a loss under same, and the Underwriters at Lloyds of London paid the Interior Warehouse Company the sum of $5,562.33 as and for a loss under its said policy of insurance (Tr. 98). Thereafter, Lloyds of London assigned any and all its rights of subrogation by reason of its payment under said policy to E. L. McDougal, plaintiff.

The case was tried by the court sitting without intervention of a jury and thereafter the court made Findings of Fact and Conclusions of Law and entered judgment thereon in favor of appellee. (Tr. 44, 68) from which judgment this appeal is taken.

SPECIFICATIONS OF ERROR

1. The court erred in Finding of Fact VI (Tr. 59-60) in stating that, with respect to the eighteen checks of which the originals were not introduced in evidence, there was no evidence "of any of the endorsements on the back thereof, if any, other than the oral testimony of Garth L. Crowe that he endorsed the names of said respective payees on the several checks"; and appellants contend that there is other evidence in the record regard-

ing said endorsements, and that said endorsements were clearly forgeries. This specification of error is probably immaterial in view of Finding of Fact VII (Tr. 60) that the names of payees in all checks involved "were forged by the said Garth L. Crowe."

2. The court erred in entering Finding of Fact XIV (Tr. 64) to the effect that Interior Warehouse Company did not discover the negotiation and cashing of said checks by said Crowe within a reasonable time after the negotiation and cashing of the same, and that Interior Warehouse Company thereby misled defendant and the prior endorsers on said checks. It is the contention of appellants that the discovery of the negotiation and cashing of said checks by said Crowe was, in view of all the facts and circumstances, within a reasonable time. Appellants further contend that the evidence conclusively proves that any failure to discover said negotiation and cashing of said checks was not the proximate cause of the losses in this case.

3. The court erred in Finding of Fact XV (Tr. 64) in which the court found that defendant was not guilty of any negligence or wrongdoing in the cashing of said checks, or any of them, or in charging them to the account of Interior Warehouse Company in defendant bank and in further finding that defendant was not involved in any manner in the misconduct of said Crowe

in his negotiation and cashing of said checks, or any of them. Appellants contend that these findings are erroneous and because the evidence conclusively proves that defendant was guilty of negligence and, more important, was guilty of a violation of a positive duty owed by defendant to Interior Warehouse Company in that in the case of each of said checks defendant wrongfully charged the same against Interior Warehouse Company, although, as the evidence proved and the court found, the payee's endorsement on each of said checks was forged. Appellants further contend that such violation of duty rendered defendant liable to Interior Warehouse Company regardless of negligence, but also contends that the evidence discloses that defendant was negligent in cashing each of said checks.

4. The court erred in Conclusion of Law III (Tr. 65) in holding that "the better view of the law is that the failure of Interior Warehouse Company to discover the negotiation and cashing of said checks by said Crowe within a reasonable time thereafter justifies a denial of recovery against defendant herein either on principles of negligence of Interior Warehouse Company or estoppel against it." Appellants contend that (1) said conclusion of law is based on the erroneous assumption of fact that Interior Warehouse Company failed to discover said negotiation and cashing within a reasonable time;

and (2) even had such been the fact such fact would not justify a denial of recovery against defendant either on principles of negligence or on principles of estoppel.

5. The court erred in Conclusion of Law IV (Tr. 65) in holding that the principle of election of remedies has any application to this case. While it is true that Interior Warehouse Company had the right either to proceed against defendant or to recover from the insurers upon their respective insurance policies, the election to recover from the insurers and the consequent payment of the loss by the insurers transferred to insurers by subrogation all remedies which Interior Warehouse Company otherwise had against defendant.

6. The court erred in Conclusion of Law V (Tr. 66) in which the court held that the fact that there were two "independent contractual obligations" in favor of Interior Warehouse Company prevents the doctrine of subrogation from being applicable, and that the payment by insurers "did not give rise to a real or equitable or any right in them or their assignee or assignees to recover against defendant in this cause." It is the position of appellants that despite the existence of "independent contractual obligations," the doctrines of subrogation are applicable.

7. The court erred in Conclusion of Law VI (Tr. 66-67) in holding that

> "The fact that Interior Warehouse Company may have had another remedy against defendant on a different contract if Crowe had not been insured does not render defendant liable to the insurers, who as to it stand in the same position as Crowe."

It is the position of appellants that the insurers do not "stand in the same position as Crowe," but rather that insurers stand in the same position as Interior Warehouse Company, and that insurers were therefore subrogated to the rights not of Crowe but of Interior Warehouse Company.

The court also erred in said Conclusion of Law VI in holding that as a result of said payment by insurers, "there was no claim against defendant which could be assigned or which could inure to the insurers or either of them, by subrogation." It is the position of appellants that the very fact of payment resulted in insurers being subrogated to the claim of Interior Warehouse Company against defendant.

8. The court erred in Conclusion of Law VII (Tr. 67) in holding that appellants are not entitled to recover either on principles of assignment or on principles of subrogation. The grounds of this error are the same as those stated in the preceding specifications 4, 5, 6 and 7.

9. The court erred in Conclusion of Law VIII (Tr. 67) in holding that judgment should be entered in favor

of defendant and against plaintiff, for the reasons hereinbefore stated.

10. The court erred in failing to enter judgment in favor of appellants, and in entering judgment in favor of appellee (Tr. 68-69).

SUMMARY OF ARGUMENT

On the merits, this case involves two questions, (1) Is the bank liable to its depositor for the sum of $6,562.33 which it charged to its depositor's account in making payment of these 126 checks, the payees' endorsements of which were forged? and (2) Are the appellants by reason of their payments to the depositor, their assured, subrogated to its right to collect said sum from the bank? All the issues presented by the pre-trial order deal with a determination of these two primary questions which are before this Court for its determination.

It is the contention of the appellants that the checks involved were "order" instruments and the bank in paying same when the indorsements thereon were forged and charging the amounts thereof from the deposit account of the drawer, Interior Warehouse Company, breached its contract with its depositor and became liable to it for the amount of money it thus wrongfully charged to said account.

It is likewise the position and contention of appellants that upon the payment by the American Surety Company and Lloyds of London of the said sum of $6,562.33 to the Interior Warehouse Company, pursuant to the provisions of their respective policies, the said American Surety Company and Lloyds of London became subrogated to the rights of the Interior Warehouse Company against the defendant bank. E. L. McDougal, by reason of the assignment, has succeeded to said rights of Lloyds of London. At the time the payments were made to it by its insurers, the Interior Warehouse Company was entitled to recover the said sum of $6,562.33 from defendant bank and under the right of subrogation, plaintiffs are entitled to a judgment against the bank for said sum.

ARGUMENT

The law dealing with the relationship between a bank and its depositor and the rights, duties and liabilities as between them is established and well settled. (See Appendix A.) There is nothing new or novel about the facts of this case nor the methods pursued by the defalcating employee Crowe. The scheme employed by him has been attempted and carried out by many employees of large concerns in various parts of the country and there are numerous decisions of the courts in various

jurisdictions dealing with the legal problems present in the instant case. Under the authority of these cases, which will be discussed and called to the Court's attention, and the facts in this case as disclosed by the Transcript of Record, appellants are entitled to a judgment against appellee.

I. LIABILITY OF THE BANK

The Contract Relationship Between a Bank and Its Depositor

The making of a deposit by a depositor in a bank for the purpose of drawing checks thereon creates a relationship between the bank and the depositor which rests upon contract. The bank by the mere act of accepting the deposit becomes bound by law from the fact of the deposit of the money to repay it on the depositor's demand or order to the persons to whose order the checks are drawn, and to them only, *Zollman, Banks & Banking,* Sec. 3332. The New York Court of Appeals in the leading case of *Shipman et al vs. Bank of State of New York,* 126 N. Y. 318, 27 N. E. 371, said:

> "The various deposits of money, made from time to time by the plaintiffs with the defendant, created the relation of debtor and creditors, and the law implies a contract on the part of the defendant to disburse the money standing to the plaintiffs' credit only upon their order and in conformity with their directions. The defendant is not entitled to charge against

the plaintiffs' account any sums as payments, unless they have been made to such persons as the plaintiffs directed. Such payments as were made without the order of the plaintiffs of their funds by the defendant afford to it no protection, when called upon by the plaintiffs to account for the money deposited."

A similar statement of this rule is made by the Supreme Judicial Court of Massachusetts in the case of *Jordan Marsh Co. vs. National Shawmut Bank,* 201 Mass. 408, 87 N. E. 740:

"The implied contract between the banker and his depositors in regard to the depositor's checks is that the banker will pay them from his deposit to the persons to whom he orders payment to be made. When a definite order is made in the check, the duty of the banker is absolute, as a general rule, to pay only in accordance with the order."

In the recent case of *Board of Education vs. National Union Bank,* 16 N. J. M. 50, 196 A. 352, Affd., 121 N. J. L. 177, 1 A. (2d) 383, the Supreme Court of New Jersey stated:

". . . the implied contract on the part of the defendant bank that it would disburse the money standing to the credit of the board (the depositor) only on its order and in conformity with its directions, and when it paid the checks in question, to which the names of the necessary indorsers had been forged, it must be considered as having paid out its own funds and could not charge the account with the amount."

At page 829 the Supreme Court of Illinois in the case of *United States C. S. Co. vs. Central Mfg. Dist. Bank,* 343 Ill. 503, 175 N. E. 825, said:

> "Out of the relation of debtor and creditor existing between banks and their depositors, the law implies the contract on the part of the bank to pay the depositor's checks, to the amount of his deposit, to the persons to whom he orders payment to be made. If the check is made payable to the order of a person named, the duty of the bank is absolute to pay only to the payee or according to his order. No amount of care to avoid error will protect the bank from liability, if it pays the check to a wrong person, and it must ascertain and act upon the genuineness of the indorsement at its peril." (Citations of cases omitted.)

The same principle is recognized and set forth by the Supreme Court of California in the case of *Los Angeles Invest. Co. vs. Home Savings Bank,* 180 Cal. 601, 182 P. 293, 5 A.L.R. 1193; by the Supreme Court of Michigan in *Detroit P. R. Co. vs. Wayne County and H. Sav. Bank,* 252 Mich. 163, 233 N. W. 185, 75 A.L.R. 1273, and by the Supreme Court of Missouri in the case of *American Sash & Door Co. vs. Commerce Trust Co.,* 332 Mo. 98, 56 S. W. (2d) 1034.

The United States Supreme Court, in *Leather Manufacturers' Bank vs. Merchants' Bank,* 128 U. S. 26, at page 34, 9 S. Ct. 3, 4, 32 L. Ed. 342, states the rule governing the relation of a bank and its depositor as follows:

"Its obligation to the depositor is only to pay out an equal amount upon his demand or order; and proof of refusal or neglect to pay upon such demand or order is necessary to sustain an action by the depositor against the bank. The bank cannot discharge its liability to account with the depositor to the extent of the deposit, except by payment to him, or to the holder of a written order from him, usually in the form of a check. *If the bank pays out money to the holder of a check upon which the name of the depositor, or of a payee or indorsee, is forged, it is simply no payment as between the bank and the depositor; and the legal state of the account between them, and the legal liability of the bank to him, remain just as if the pretended payment had not been made.*" (Emphasis ours.)

See also *United States v. National Bank of Commerce,* (C.C.A. 9th) 205 F. 433.

In each of the above cases (except Leather Mfrs. Bank vs. Merchants' Bank, supra), a dishonest employee of a depositor by a fraudulent scheme similar to that used by Crowe secured checks payable to designated payees and thereon forged the indorsement of the named payee. In each of these cases the court dealt with practically every legal question now before this court.

Banks Specific Duty to Pay Only on a Genuine Indorsement

The above discussed duty of the bank imposes upon the bank the specific duty of determining at its own peril the genuineness of the payee's indorsement. In the

case of *Shipman et al vs. Bank of State of New York, supra,* the court said:

> "The defendant's contract was to pay the checks only upon a genuine indorsement. The drawer is not presumed to know, and in fact seldom does know, the signature of the payee. *The bank must, at its own peril, determine that question."* (Emphasis ours.)

In the case of *Jordan Marsh Co. vs. National Shawmut Bank, supra,* in speaking upon precisely the same question, the court said:

> "If the payment is to be made to the order of a person named in the check, and if he orders the payment to be made to another person, it is the duty of the banker to see that the signature of the payee is genuine." (Cases cited omitted.) . . . *"This rule of law applies as well to payments made by a banker through the clearing house as to payments made over the counter. The duty is the same and the performance of it is as important in one case as in the other. If the methods of the clearing house are a convenience to bankers in the transaction of their business, and the bank on which a check is drawn chooses to pay on a guaranty of the indorsement of the payee's name by another responsible bank, this does not affect the duty of a paying bank to its depositor.* It simply indicates a willingness of the bank to disregard and neglect the duty, upon the guaranty of a responsible party that the duty has already been perfectly performed for it by a preceding party from whom the check has been received . . ." (Emphasis ours.)

See also the quotation from the *United States C. S. Co. vs. Central Mfg. Dist. Bank, supra.*

From these authorities it is apparent that the duty to detect the forgery of the payee's name is an absolute duty assumed by the bank arising from its contract with its depositor. The drawee bank is duty bound to the drawer not to pay an order instrument unless it is properly indorsed by the payee or his duly authorized agent. It cannot escape this duty owing to its depositor by its reliance upon the integrity and indorsements of subsequent indorsers or the indorsement of a member bank of the same clearing house. Such reliance by it in its commercial dealings with such indorsers and member banks is a matter between it and them, but that does not relieve it from this positive contractual duty owing its depositor to pay only on the order of the payee. The duty to detect the forgery of the payee's name is a risk assumed by the bank arising from its contract with its depositor. If it sees fit to rely upon the endorsement of the party who cashed the check in the first instance, or subsequent indorsers, such reliance does not in any way release it of its primary obligation to the depositor. As between the bank and its depositor the loss falls upon the bank.

Such is the situation in the instant case. As a practical matter, it may be that this is the only way a bank in a large city may proceed, but such rule is one of expediency and necessity in the maintenance of checking accounts and in order to obtain the full benefit and

convenience of the system of commercial banking, and the use of negotiable instruments, in which system the appellee bank is a part and from which it derives its existence and benefits.

Any apparent harshness of such rule disappears in view of the equally settled and well established rule of negotiable instruments that each indorser guarantees the genuineness of prior indorsements. *O.C.L.A.,* Secs. 69-506, 69-507; *First Nat. Bank vs. United States Nat. Bank,* 100 Or. 264, 197 P. 547. Under the facts in this case the bank had an absolute right to obtain complete recovery from the member banks of the clearing house and other indorsers subsequent to the forged indorsement for the sums it paid out, who in turn would have a right of recourse against prior indorsers. And under the Rules of Civil Procedure, it could have brought in as parties in the instant case those who were liable to it. In this way the liability for this loss would have been placed upon those directly responsible for it, namely those who dealt with the forger.

The Checks Are "Order" Instruments

The checks involved in this case are not "bearer" instruments, but "order" instruments. Some were made payable to living persons. In some the payees named were non-existent persons—the names used as payees

were fictitious. All the checks were prepared under Crowe's direction. All were signed by duly authorized officers of the Interior Warehouse Company, who at the time of signing the checks believed that the Interior Warehouse Company was indebted to living persons— their employees— named as payees in the checks for the respective amounts thereof. They intended the checks for the payees named therein and did not know that any of the checks were drawn payable to non-existent persons. They also intended and believed that the checks would be delivered to the persons named therein as payees. (Tr. 150-152, 155, 156.)

It is the intention of the drawer of the checks that controls and that makes these checks "order" instruments. In this case it was the intention of the men who signed the checks that controlled—not the intentions of the faithless servant who presented the prepared but unsigned checks to these officers. Checks made payable to the order of fictitious persons are "bearer" instruments only when the person signing the checks knows of that fact, and intends to make the checks payable to a fictitious person. The Negotiable Instruments Act (Sec. 9-3) provides that an instrument payable to a "fictitious or non-existing person" is payable to bearer only when "such fact was known to the person making it so payable." (O.C.L.A., Sec. 69-109.)

The knowledge of Crowe is not imputable to the Interior Warehouse Company.

A clear statement of the law dealing with this question is found in 9 C.J.S. at p. 740, which statement is amply supported by the cases cited (see also 1941 Pocket Part) and is set forth fully in Appendix B to this brief.

In holding that the knowledge of the agent is not imputable to the drawer of the check, the court in *United States C. S. C. vs. Central Mfg. Dist. Bank, supra* (343 Ill. 503, 175 N. E. 825), quoting from *Los Angeles Investment Co. vs. Home Savings Bank, supra* (180 Cal. 601, 182 P. 293), stated:

> ". . . The point in this case is that the checks were not executed by the guilty agent; we are not concerned with an act done by him within the scope of his authority, and therefore his guilty intent and knowledge are not the intent and knowledge of his principal. The intent and the knowledge of the principal was, as we have said, that of the officers who drew the checks, and they were wholly innocent of any intention of drawing checks to fictitious payees."

In practically every one of the cases above cited, where a scheme such as that employed by Crowe was followed, the dishonest employee had checks made out to non-existent persons as well as existing persons to whom the depositor did not owe any money. But in said cases as in the instant case the person authorized

to sign the checks was led to believe by the fraudulent acts of the faithless employee that the named payee was in fact a real person entitled to be paid the amount of the check.

In *Shipman et al vs. Bank of State of New York, supra* (126 N. Y. 318, 27 N. E. 371), the checks were filled up (not signed) by one Dodge, the cashier, from a written statement made by Bedell, the dishonest employee, showing the amount to be paid plaintiffs' clients and the basis for said payment. After filling up the checks Dodge would take the check book with the filled up checks, to a member of plaintiffs' firm for signature, showing him the supporting documents for the payment and the statement of Bedell as to the payments to be made. Thereupon, the checks would be signed by the plaintiffs, in the name of the individual partner to whom it was presented by Dodge, the firm name being engraved on each check and the individual signature written underneath. Dodge would then take away the check book and deliver the several checks to Bedell for delivery to the respective payees. Bedell then forged the names of the payees. The New York Court of Appeals held that the checks were order instruments and the depositor was entitled to recover the amount the bank paid as forged indorsements. See statement of court in Appendix C.

In *American Sash & Door Co. vs. Commerce Trust Co., supra,* as shown by the facts in the opinion, the timekeeper followed a scheme very similar to that employed in the instant case by adding names to a payroll and turning same over to a bookkeeper who made out the checks and handed them to the officer of the plaintiff company authorized to sign the checks. The timekeeper added the name of one non-existent person and the names of six former employees to the payroll. After the checks were signed they were returned to the timekeeper for distribution. He kept the checks and forged the names of the payees. The excellent statement of the court holding such checks to be order instruments is set forth in Appendix D. In its well considered opinion the court points out that the guilty knowledge and fraudulent intent of the agent is not imputed to his employer or those authorized to sign the checks.

In *Los Angeles Invest. Co. vs. Home Savings Bank, supra,* a similar fraudulent scheme was employed, as shown by the facts stated in the opinion. In that case the manager of the fire insurance department of a company engaged in the real estate business presented to the proper officer who had authority to sign checks requisitions for the payment of claims of fictitious persons, and of real persons to whom the manager had no intention of making any payments. These ostensible

claims against the company did not in fact exist. A check in accordance with the demand was prepared and also presented to the officer authorized to sign checks. The signed checks were then returned to the manager who indorsed them in the name of the payees and converted the money to his own use. The court held that the intention of the manager that the checks be made payable to persons who were not to receive them was not attributable to the company, and therefore the checks, though payable to fictitious persons as to the manager, were not payable to fictitious persons as to the company. Hence, they were order instruments and not payable to bearer and the bank upon which they were drawn was liable to the company, its depositor, because of its payment of the checks on the forged indorsements. In concluding its statement on this question the court said:

> ". . . The intent and knowledge of the principal was, as we have said, that of the officers who drew the checks and they were wholly innocent of any intention of drawing checks to fictitious payees."

The decision in the case of *Board of Education vs. National Union Bank, supra* (16 N. J. M. 50, 192 A. 352, Aff'd. 121 N. J. L. 177, 1 A. (2d) 383), also treats this question fully and supports plaintiff's contention that these checks were "order" instruments and that the indorsements by Crowe constituted forged indorsements,

making the bank liable to the Interior Warehouse Company for the amount of these checks charged to the latter's account.

Depositor's Duty to Bank

We have discussed above the bank's duty to its depositor, and it may fairly be asked at this time, What is the depositor's duty to the bank arising from the contractual relationship existing between them? The appellee by its answer and the pre-trial order by issues 18, 19, 20 and 21 of Article VII (Tr. 40) have injected into the case the question of the effect of the bank statements and the canceled checks which are returned monthly to the depositor. Included in these returned cancelled checks were those bearing the forged indorsements. On the statement of the bank were the following words:

> "Please examine at once. If no error is reported within ten days, the account will be considered correct."

It is the contention of appellants that the issues thus made are not material or relevant to the case and our position is noted in the pre-trial order (Tr. 42).

At the outset we call this Court's attention to the fact that we are dealing with forged indorsements of the *payees,* and not a forgery of the drawer's signature or an alteration or irregularity appearing upon the face

of the checks. The duty of the depositor to examine the returned checks and statements for forgeries, alterations or irregularities on the face of the checks differs from his duty to examine returned checks for forged indorsements and the law recognizes this difference.

The duty of the depositor does not extend to the examination of indorsements on the returned checks, as he is justified in relying on the bank's observing proper precaution to see that payment is made only in accordance with his directions, and he is not bound to know the signatures of the payees or other indorsers.

Los Angeles Inv. Co. vs. Home Sav. Bank of Los Angeles, supra.

Detroit Piston Ring Co. vs. Wayne County, etc. Bank, supra.

American Sash & Door Co. vs. Commerce Trust Co., supra.

In practically every case referred to this Court in this brief involving a scheme similar to that employed by Crowe, the drawee bank in resisting payment has raised a defense based upon its monthly statement and returned checks. They usually assert (1) that an account stated has arisen between the bank and the depositor, and (2) that the depositor's negligence in failing to discover the forged indorsements bars its right to recover.

Such a defense was squarely raised in *National Surety Co. vs. Manhattan Co.,* 252 N. Y. 247, 119 N. E. 372. In that case thirty-nine checks drawn between January, 1921, and June, 1923, were involved and between said dates the bank returned the checks of its depositor monthly together with a statement. At the request of the bank *the depositor each month returned to it a writing acknowledging the receipt of the vouchers and statement and the correctness of the statement.* The New York Court of Appeals in holding that no account stated was created quotes from *Shipman vs. Bank of State, supra,* the following:

> "The statement of the account made by the defendant to the plaintiffs, from time to time, the balancing of the bank pass book, and the return of the same to the plaintiffs with the vouchers, including, as they did, the checks in controversy, with the forged indorsements thereon, constitute no obstacle to the maintenance of this action by the plaintiffs, as they were ignorant of the facts and circumstances under which the checks were issued and put in circulation."

In dealing with the questions of the depositor's negligence, the court first points out in the opinion facts dealing with the manner of the employee's conduct, which facts in themselves show that the forgery could more easily have been discovered from an examination of the checks than in the instant case. The clerk in that case was possessed of no assets, but was indebted to his em-

ployer in the sum of $26,000.00. No such circumstance was present in the instant case. In placing a forged indorsement of the payee's name upon the back of the first check as well as on all the subsequent checks, he made no attempt to simulate the handwriting of the payee. And on every check forged by him, he placed his own indorsement beneath the forged indorsement. Crowe did not do this, the record showing only seven checks, with long intervals of time between same, that bear his own signature. Also, in the discussed case, the employee deposited every check in his own account in the Bank of America, whereas Crowe did not deposit these checks to an account. The court points out that if an examination of the indorsements on the returned checks had been made, the depositor's suspicions would easily have been aroused because of such facts, and the "story of the forgeries would have been revealed." But in holding that this was not a defense available to the bank, the court stated the law as follows:

> "The difficulty is that no duty rested upon the depositor, upon the return of its vouchers by the bank of deposit, to examine the indorsements upon the checks in order to discover whether the signatures indorsed were genuine. Welch vs. German American Bank, 73 N. Y. 424, 29 Am. Rep. 175; Shipman vs. Bank of State, supra. In Welch vs. German American Bank, supra, the decision is correctly expressed in the headnote, as follows: 'A depositor owes no duty to a bank requiring him to examine his pass book or returned checks, with a view to the detection of

> forgeries in the indorsements; he has a right to assume that the bank, before paying his checks, will ascertain the genuineness of the indorsements'."

And in *Los Angeles Invest. Co. vs. Home Sav. Bank, supra* (180 Cal. 601, 182 P. 293), in discussing this question the court follows the rules laid down in the Shipman case that no account stated is created and also no duty rests on the depositor to examine the indorsements. As to this last the court said:

> ". . . But a depositor is not bound to examine the indorsements on returned checks. He is bound within a reasonable time to ascertain the genuineness of the checks themselves (Janin vs. London & S. F. Bank, 92 Cal. 14, 14 L.R.A. 320, 27 Am. St. Rep. 82, 27 Pac. 1100); but, as to indorsements, the rule and its reason are correctly stated in Shipman vs. Bank of State, 126 N. Y. 318, 12 L.R.A. 791, 22 Am. St. Rep. 821, 27 N. E. 371. '. . . When it returns the check to the depositor, as evidence of a payment made by his direction, the latter has the right to assume that the bank has ascertained the fact to be that the indorsement is genuine'." (Citing a host of cases.)

In view of the fact that the law on this point is so well settled and has been passed upon in practically every case involving continued forged indorsements by an employee, there is no need to extend this discussion further by citing more cases or discussing the evidence, but we do call this Court's attention particularly to the

well considered opinion in *American Sash & Door Co. vs. Commerce Trust Co., supra,* and *John G. Patton vs. Guaranty Trust Co.,* 238 N. Y. S. 362, 227 A. D. 545, Aff'd. 254 N. Y. 621, 173 N. E. 893. In this latter case the court stated that only three things are required of the depositor: (1) compare the vouchers returned by the bank with the check stubs in his stub book; (2) compare the balance entered in the statement (or pass book) with the balance in his stub book; (3) compare the returned vouchers with the list of checks entered in the statement.

Thus it is obvious that the language "If no error is reported within ten days the account will be considered correct," does not in any way go to relieve the defendant from the duty to ascertain, at its peril, the genuineness of the payee's indorsement or release it from obligations incurred by its failure so to do.

Failure of Depositor to Discover Forgeries

Closely connected with the foregoing charge of negligence of the depositor in the examination of the returned cancelled checks and the bank statements is the charge that the employer-depositor was negligent in failing to discover the forgeries and the cashing of the checks within a reasonable time thereafter. (Paragraph III, Conclusion of Law, Tr. 65.) This defense likewise has

been raised by the banks in practically every one of the cases cited to this Court in this brief.

It is the position and contention of appellants, first, that as a matter of law the Interior Warehouse Company was not negligent, and secondly, that even if it could be considered that the company was negligent, such negligence was not the proximate cause of the loss so as to defeat recovery from the bank. In the language of the courts, as expressed in the cases hereinafter cited and discussed, such failure to discover the fraudulent acts of the employee neither "induced or contributed to the payment of these checks by the banks."

Between October 2nd, 1935, the date of the first check bearing the forged indorsement, and April 21st, 1939, the date of the last check bearing the forged indorsement, Crowe forged the payee's name on 126 checks. The checks are set forth in chronological order as to time in Findings of Fact V and VI (Tr., pp. 46 to 59). This record shows that during this period of 44 months, Crowe did not obtain a great number of checks in any one month. In only two months, December, 1937, and August, 1936, did the number reach six. In six months, September, 1936, and July, September and November of 1938, and February and June of 1938, the number was five. In the remaining months two, three

or four checks were obtained and in many months no checks were obtained.

Yet during this period, according to defendant's exhibit 24 (see stipulation Tr. 99 at p. 100), the "cancelled checks and bank statements delivered by the defendant, the Bank of California, to said Interior Warehouse Company, each month covering the period from January, 1935, to June, 1939, and that *the average number of checks per month was approximately* 275."

Thus the number of irregular checks as compared with the number of proper checks issued each month was exceedingly small and the amount of these checks as compared with the total amount of all the checks was likewise small.

The manner whereby the amounts of these checks were concealed in the records of the Interior Warehouse Company is set forth in Paragraph IX of the Findings of Fact (Tr. 61):

> "During the entire period of the said negotiation and cashing of said checks by said Garth L. Crowe and in order to account for the same on the books and records of said Interior Warehouse Company, he made irregular and improper entries therein by the following methods:
>
> (a) Increasing dock and country payrolls by adding names and amounts thereto.
>
> (b) Recording in the monthly summary sheet a larger amount than the dock payroll actually showed. [60]

(c) Raising amounts properly due employees.

(d) Charging labor, repairs, insurance or other expense accounts without proper support, the contra entries being to accounts payable to which irregular disbursements had been charged.

(e) Making direct entries in the ledger without support in a book of original entry."

Also, during this entire period the Interior Warehouse Company employed Price, Waterhouse and Company, certified public accountants, to audit its books, which audits were made annually (Tr. 137). In making these audits they would test check the payroll records and the checks issued to payroll employees with the payroll accounts and time books. (Tr. 136, 137 and 142 to 148.) But during all of these audits for the years 1935 to 1939 they failed to discover any irregularities in the records of the company which would throw suspicion on Crowe or that irregularities existed in the bookkeeping or the issuance of checks. Even with respect to the existence of voided checks (the nineteen originals of which Crowe destroyed after forging the indorsements) the accountants did not find this procedure unusual as the testimony of Mr. Rawlinson shows:

"A. There weren't a large number of checks that were voided. Every company has some checks that were voided. Sometimes it is carelessness on the part of employees; sometimes they destroy them and sometimes they retain them. Some companies retain them and some companies don't.

Q. Weren't there quite a number in this case, Mr. Rawlinson?

A. I wouldn't say that there was an abnormal number. The number of checks voided that way depends quite often on the carelessness or the efficiency of a girl making out payrolls . . ." (Tr. 146.)

* * * * * *

"A. There was no particular suspicion aroused by having a check marked void.

Q. No, but the number you did find in here—

A. (Interrupting): I say, in this particular case the number of voided checks in this company never struck me as being out of the way." (Tr. 147.)

As pointed out above in our Statement of the Case, the discovery of the irregularities was made by an accountant of Price, Waterhouse & Co. by accident when he noticed that an address on a cancelled check payable to an employee in eastern Washington was the address of his personal friend (Tr. 109).

In view of these facts how can it be said that Interior Warehouse Company did not discover the negotiation and cashing of said checks by Crowe within a reasonable time? Here is a firm of accountants, specialists in the work of auditing books, who made repeated audits, and yet found no discrepancies in the records, but chanced upon the acts of Crowe by pure accident.

The burden of proving negligence of the depositor is upon the bank, *U. S. Cold Storage Co. v. Central Mfg. Dist. Bank, supra,* (343 Ill. 503, 175 N. E. 825)

American Sash & Door Co. v. Commerce Trust Co., supra, (332 Mo. 98, 56 S. W. (2d.) 1034). *Los Angeles Invest. Co. v. Home Sav. Bank, supra,* (180 Cal. 601, 182 P. 293). The evidence in the case does not tend to prove such negligence but on the contrary shows the skill by which Crowe operated and the difficulty in discovering it.

Furthermore, in this case there is no evidence of any circumstances which would cause a reasonably prudent employer to suspect his bookkeeper or payroll clerk. No evidence was introduced to show that Crowe lived beyond his means, buying expensive clothes or cars, or that he gambled and drank, or borrowed money, etc. facts which would cause an employer to suspect an employee working for a modest salary. The payroll expense of the company did not increase beyond its normal proportion and relationship to the operation of the business, nor did any other item of expense show an abnormal increase so as to cause the company to seek a reason for it. See *Detroit Piston Ring Co. v. Wayne County Home & Sav. Bank, supra,* (252 Mich. 163, 233 N.W. 185). The record is devoid of any evidence of negligence on the part of the Interior Warehouse Company in failing to discover forgeries.

Can it be said that Interior Warehouse Company failed to discover these forgeries because it trusted Crowe,

and therefore it was negligent? In *Los Angeles Invest. Co. v. Home Sav. Bank, supra,* the court said:

> ". . . Complaint is chiefly made that the company relied upon the honesty of its heads of departments and the regularity on their face of the demands or requisitions which such heads approved, and made no investigation to determine whether such demands were fraudulent or not. But trust must be placed in someone (Kohn v. Sacramento Electric, Gas & R. Co., 168 Cal. 1, 141 Pac. 626; The Yamato v. Bank of Southern California, 170 Cal. 351, 149 Pac. 826), and necessarily in heads of departments. If trusting them in regard to demands for checks for disbursements regular upon their face is negligence, so it would be negligence to trust them in a hundred other ways in which it is within their power to defraud their employer. Business could not be conducted on any such basis. It is impossible for any large concern to investigate minutely in advance every demand for disbursement necessary for it to make in its daily business. The delay and expense of so doing would be too great."

The above statement is approved and quoted in full by the Supreme Court of Illinois in *United States C. S. Co. v. Central Mfg. Dist. Bank, Supra.*

But even if it could be said that the Interior Warehouse company failed to discover the dishonest acts and forgeries of Crowe within a reasonable time after their occurrence such failure would not relieve the bank from its liability because such failure was not the proximate cause of the payment of the checks by the bank. As stated by the courts in the two cases last cited above:

"But however this may be, even if the company were guilty of negligence in signing the checks upon the fraudulent demands of Emory, it is plain that such negligence did not contribute to or induce the acceptance by the banks of the forged indorsements. The forgery of the indorsements was entirely distinct from the issuance of the checks on false demands, and there was no relation between them."

The negligence of the drawer of a check is immaterial unless it is such as directly and proximately affects the conduct of the bank in the performance of its duties.

See last cited cases and

Jordan-Marsh Co. v. National Shawmut Bank, supra, (201 Mass. 408, 87 N. E. 740)

Shipman v. Bank of State, supra, (126 N. Y. 318, 27 N. E. 371).

John G. Patton Co. v. Guaranty Trust Co., supra, (238 N. Y. S. 362, 227 A. D. 545 Aff'd 254 N. Y. 621, 173 N. E. 893).

In this last case the Court said:

"The only negligence which the defendant may take advantage of to relieve itself from liability is the omission by the plaintiff to perform some duty which it owed to the bank. The plaintiff owed the bank no duty to keep a proper set of books and records or to keep any books of record whatsoever except a check book and check stubs. Therefore whether the plaintiff had a proper bookkeeping system and kept proper records is immaterial. *Nor was the plaintiff negligent in employing Ham and relying, implicitly upon his honesty and integrity until it had some notice to the contrary.*

A bank that has paid out money upon forged indorsements may relieve itself from liability only by establishing that the *payment was induced* by the depositors negligence and that in making the payment it was free from any negligence. This is an affirmative defense, and the bank has the burden of proving not only the depositor's negligence *but its own freedom from negligence.*" (Emphasis ours)

In this case, the depositor's failure to discover the dishonest acts of Crowe, if negligence at all, was not the proximate cause of the loss. The proximate cause of the loss was the cashing of the checks by the Meier & Frank Co. and the other business firms without seeking proper identification from the forger Crowe at the time he indorsed and cashed the checks. The bank, as pointed out above, in willingly accepting the acts of the subsequent indorsers and collecting banks as the fulfillment of its duty to its depositor is bound by their negligence and accepted it as the act whereby they breached their contract to the depositor. Regardless of any negligence of the Interior Warehouse Company whereby Crowe was able to fraudulently obtain these checks and forge the payees' names thereon (and we deny there was any such negligence) had those to whom they were presented required proper identification, no loss would have occurred. It was their negligence and in turn the bank's adoption of their acts for the fulfillment of its duty which occasioned the loss and constituted the proximate cause thereof.

II. SUBROGATION

The American Surety Company and Lloyds of London in consideration of premiums paid them by the Interior Warehouse Company respectively issued policies whereby each insured the Interior Warehouse Company against a loss such as occurred in this case. Upon discovery of the forged checks the Interior Warehouse Company, by Exhibits 10 and 11, made proofs of loss, and thereafter the American Surety Company and Lloyds of London paid the Warehouse Company by checks, Plaintiffs Exhibits 12, 13 and 13 A, the total amount of the forged checks. (Stipulation re Exhibits, Tr. 98).

An insurer, upon paying a loss, is subrogated to the insured's right of action against any other person responsible for the loss. This right of the insurer against any such other person arises out of the nature of the contract of insurance as a contract of indemnity. Subrogation, it has been said, is a normal incident of indemnity insurance.

This right of an insurance company to be subrogated to "all the means of redress held by the party indemnified against the party who has occasioned the loss" is the law of Oregon as shown by the Oregon cases, *United States Fidelity Co. v. United States Nat. Bank,* 80 Or. 361, 157 P. 155, and *American Central Insurance Co. v. Weller,* 106 Or. 494, 502, 212 P. 803, cited by Judge Fee in

his opinion (Tr. 78, 79). He quotes the following from the Weller case (Tr. p. 79):

> " 'One who has indemnified another in pursuance of his obligation so to do succeeds to, and is entitled to, a cession of all the means of redress held by the party indemnified against the party who has occasioned.'
>
> "4. It is unquestionably the general rule that on payment of a loss, the insurer acquires the right to be subrogated *pro tanto* to any right of action which the insured may have against any third person whose wrongful act or neglect caused the loss * * *"

Such being the law, appellants by this appeal seek its application to them as indemnitors.

The following cases are cited as entitling them to recover under the principle of subrogation. These cases involved fact situations similar to the instant case.

Tarrant American Savings Bond Co. v. Smokeless Fuel Co., 733 Ala. 507, 172 So. 603.

National Surety Co. v. President and Directors of Manhattan Co., supra.

National Surety Co. v. National City Bank, 172 N. Y. S. 412.

American Surety Co. v. Empire Trust Co., 240 N. Y. S. 413.

Grubnau v. Centennial Natl. Bank, 124 A. 142, 279 Pa. 501.

New Amsterdam Cas. Co. v. Albia State Bank, 214 Ia. 541, 239 N. W. 4.

In some of the above cases the insurance companies obtained assignments, but as pointed out by courts, an assignment does not add to the insurer's rights. In 60 *C. J. p.* 749, it is stated:

> "While the creditor may properly make an assignment of his rights and remedies to the surety where the surety is entitled to be subrogated, the completion of the surety's subrogation, and this right to pursue the rights and remedies of the creditor, is not dependent on the willingness of the latter to make an assignment, for in equity the surety's payment causes an assignment by operation of law and no formal assignment or transfer is necessary."

If insurance companies can recover by taking an assignment from their insurers, they certainly should be allowed to recover under subrogation as it was created by courts of equity to grant the rights to the party subrogated in situations where legal assignments could not in some instances be obtained.

Judge Fee refused to follow the law of the above cases which involved fact situations similar to the instant case, but instead applied the rule of a line of cases involving a different situation, wherein the courts denied sureties the right to recover. It is also submitted that in doing so, the Honorable Trial Court refused to follow the law of Oregon as declared by the Oregon Supreme Court in *United States Fidelity Co. v. United States Nat. Bank, supra.*

Before discussing some of the cases relied upon by the learned trial judge and which authorities appellee will no doubt use in its brief, appellants call to this Court's attention the following facts which clearly distinguish the instant case from these others. Crowe was not a governmental official required by statute to post a bond inuring for the benefit of *any* person who may suffer a loss because of the dishonesty of the public official in handling public funds or in administering his office. The "bonds" or policies in the instant case were in truth, and in fact, insurance policies obtained and paid by the Interior Warehouse Company insuring it *and no one else,* for the loss covered by the said policies.

Crowe did not obtain these policies and the insurance companies were not guaranteeing his honesty to the world. These policies insured the Interior Warehouse Company, the named insured, against certain designated risks—"such pecuniary loss as the employer shall have sustained of money * * *" resulting from the acts specified. (Tr. 179, 180). Crowe was not the insured, his employer was. He was merely one of many employees and *his employer could* "add new or additional employees other than those appearing on the schedule" and they were to be "automatically added to the schedule beginning with the date" of their employment. (Tr. 182).

The Interior Warehouse Company was a depositor

in the defendant's bank, and the checks in question were *drawn* upon the defendant. A definite contract relationship existed between them arising from said relationship and, as pointed out above, under said contract relationship, the defendant owed to its depositor certain well recognized duties. One of these duties arising from this relationship existing between a bank and its depositor is that the bank can only pay out funds in accordance with the order of the depositor and the bank must, at its own peril, determine the genuineness of the payee's indorsement. This duty is absolute and any payment in violation of it is wrongful.

As this Court will discover in its examination of the cases some confusion exists in the decisions of the courts. Statements of law and application of well grounded principles properly applied in a given case to the facts of the case are carried over and wrongly applied in other cases involving a different factual situation.

The following cases:

American Bonding Co. v. State Sav. Bank, 47 Mont. 332, 133 P. 367.

National Surety Co. v. Arosin, (C.C.A. 8th) 198 F. 605.

American Bond Co. v. Welts, (C.C.A. 9th) 193 F. 978.

American Surety Co. v. Citizen's Nat. Bank, (C.C.A. 8th) 294 F. 609.

American Surety Co. v. Lewis State Bank, (C.C.A. 5th) 58 F. (2d) 559.

Stewart v. Commonwealth, 104 Ky. 489, 47 S. W. 332.

and many others, all deal with a public official who by statute or other requirements as an incident to his public employment, is required to obtain a bond covering his handling of official funds. The bond in such case is obtained by the official and covers the faithful performance of the acts of said official in his official capacity as a public officer. This duty he owes to the entire commonwealth—all its inhabitants—and the bond consequently inures to the benefit of all, the bank with which he deals as well as the sovereign State, or other Governmental agency. Cases such as this—involving such bonds—are in a class by themselves and most courts recognize this distinction.

The decisions of the courts in refusing recovery to sureties in the public official cases are based on two grounds. First, the bond (and usually by express provision of the bond itself or the statute requiring it, See *American Bonding Co. v. Welts, supra,* at p. 980) is for the faithful performance of the officials' duties and is for the benefit and protection not only of the Governmental

division but all others who might be injured by a violation of the official's duties. The bank as a depository of the public funds or as one who deals with the official is itself an obligee of the bond. In such cases *the bank itself upon reimbursing its depositor or the Governmental division could recover directly from the surety.*

The case of *American Surety Co. of N. Y. v. Robinson,* (C.C.A. 5th) 53 F. (2d) 22, clearly points this out as the basis of the rule of law applicable to sureties on bonds of public officials, stating, page 23:

> ". . . the surety may often be subrogated to the independent rights of action of the creditor against third persons. But this can never happen when such third party, if held liable in the first instance, would have had recourse over on the principal and his surety."

The court also cites and quotes from *American Bonding Co. v. Welts, supra,* as to which no additional comment is necessary to show the reasoning of this line of cases which is clearly inapplicable to the facts and situation in the instant case.

The second ground, closely associated, and which follows from the fact that the *official* is the principal on the bond, is that the loss should fall on the surety whose *principal* was dishonest. And in doing so the courts have made the statement which has been repeated, (improperly

in cases involving entirely different fact situations) that since the bank did not *actively* participate in the fraud nor was it guilty of "culpable negligence", the surety could not recover.

In the instant case, we are not asking this Court to reject the rule of these cases. We say that rule does not apply and especially it should not be applied to the facts in this case in view of the Oregon case of *U. S. F. & G. v. United States Nat. Bank, supra,* (80 Or. 361, 157 P. 155).

Crowe was not a public official obtaining a bond covering the faithful performance of his duties. The appellee bank was not a beneficiary of this policy. We do not have a bond naming Crowe as the principal but a policy of insurance in which the Interior Warehouse Company is the named insured. *Only this company*—the named insured—*could ask the insurers to pay.* The bank is neither an obligee or a beneficiary.

The excellent decision of the Circuit Court of Appeals, Eighth Circuit, in *Martin, et al v. Federal Surety Co.,* (C.C.A. 8th) 58 F. (2d) 79, shows the confusion in the decisions of the courts from the careless use of language and a failure to clearly apply the principles of subrogation. Its opinion is of special importance because it decided the case of *National Surety Co. v. Arosin,* 198 F. 605, a leading case in which a surety was denied recovery

on the ground that the bank was not negligent. (This case has since been indiscriminately cited that in order for a surety to recover from a third party it must be shown that such party was guilty of fraud or culpable negligence.) But that case did not deal with the violation of a drawee bank's duty to its depositor to pay only upon the order of the drawer.

The Martin case makes it clear that a surety may recover from a third party whose *negligence* caused the loss and clarifies the confusion, stating:

> "There is, in our judgment, no substantial basis in any of the cases in this circuit for the doctrine that in order to have the right of subrogation as against a third party, there must have been 'culpable negligence' on its part. The doctrine grew from the use by the court in National Surety Co. v. State Savings Bank of the term 'morally culpable', illustrating that while in nature 'tall oaks from little acorns grow,' in law erroneous doctrines from small phrases develop. It is fairly settled in this circuit by the decisions we have referred to that where subrogation is sought by a surety to the rights of the original creditor as against third parties, there must have been either participation in the original wrongful act or negligence on the part of the third party sought to be charged. ***But it is not necessary that such negligence be culpable or gross.***" (Emphasis ours)

It may be true in the instant case that the defendant was not guilty of "culpable negligence", whatever that term may mean, but it cannot be denied that it violated

its positive duty—a duty more stringent than the duty of reasonable care—the test of negligence. The bank in this case is not an innocent third party, but as already pointed out, was duty-bound to its depositor to determine the genuineness of the indorsements.

The case of *American Surety Co. v. Citizen's Natl. Bank, supra,* cited by the learned trial judge as an authority for denying subrogation in the instant case recognizes in its opinion the distinctions we have pointed out. That case involved a bond of a public official, but the bank in the case was not a drawee bank as is the appellee in the instant case. Note the statement of the court on page 611, after the citation of the numerous cases, where it makes a distinction between the facts before it and the facts of the cases cited dealing with the absolute duty of a bank to its depositor:

> "As between it and its depositor it is burdened with the duty of not paying forged checks, or genuine checks with forged indorsements. If it pays such checks, as between it and its depositor it must stand the loss, and cannot debit the depositors' account with the amount so paid."

The court did not have a case dealing with such facts, whereas such facts are present in the instant case.

Furthermore in the above case, Davisson, the official, was authorized to draw county funds from the bank. He

obtained *two cashiers checks* and *two drafts* and made them payable to fictitious persons to whom the county was not indebted. These instruments in fact were "bearer" instruments. There was no breach of any contract duty owing to the county. As the court said, page 613:

> "But as the county was neither drawer, payee or indorser on either cashier's checks or drafts it sustained no relation to them that put appellee under a duty to it in the respects charged; and where a defendant is under no duty, contractual or otherwise, to the plaintiff there is no cause of action for the former's negligence."

Thus in that case, even by subrogating the surety to the county's rights, no right of recovery existed. In the instant case, Interior Warehouse Company was a drawer and the bank did breach its contractual duty. The opinion therefore is not a holding for a denial of subrogation to appellants but contains a definite recognition of such right.

The learned trial judge in his opinion (Tr. 80, 85) cited *Meyers v. Bank of America,* 11 Cal. (2d) 92, 77 P. (2d) 1084, which case appellee will no doubt cite and rely upon. This was an action in the name of the plaintiff for the benefit of the United States Guaranty Company which had issued a bond indemnifying plaintiff from the wrongful acts of plaintiff's office manager. The said

manager in the course of conduct of plaintiff's business received checks payable to plaintiff, forged plaintiff's name thereon, and cashed them with one Wascher who paid full value therefor. The manager converted said sums to his own use. Wascher deposited the checks in his account with the defendant bank and the latter presented them to the respective drawees and received full payment. The Guaranty Company paid the plaintiff in full the amount of the checks so converted by the manager and the plaintiff assigned any cause of action it might have against the bank, together with the right to maintain an action at law in the name of the plaintiff.

The facts thus disclose an entirely different situation from that in the instant case. Meyers was not a depositor in defendant's bank. The relationship existing between a bank and its depositor above referred to did not exist, nor did the peculiar incidents relating to such relationship. There was no privity of contract—a contract imposing certain necessary requirements upon the bank, essential and peculiar to such relationship and in addition to the normal legal rules and principles arising from the mere transferring and negotiation of commercial paper between the general public. The action in the instant case is against the *drawee* of the checks and not against Meier & Frank Co., Inc. or the United States National Bank, or the First National Bank, collecting banks, none of which

had contracted with the Interior Warehouse Company to act as a depository and a drawee upon whom checks should be drawn. It is an action for the breach of a contract—the violation of a specific duty imposed by said contract—and not for damages for mere negligence. This factual situation cannot be lost sight of in considering this case because, as stated in dealing with the application of the doctrine of subrogation, each case must be determined in the light of the circumstances therein found.

At the outset of its opinion, the court in the *Meyers* case, (92 P. at page 1085), recognizes authorities holding contrary to the result it desires to reach. It then proceeds to discuss all the cases cited by the learned judge and relied upon by appellee in the trial court, but not one of these cases involved a situation similar to that involved in the instant case, although some of them were somewhat similar to the *Meyers* case. The results reached in those cases are based upon consideration of factors which are not present in this case, and even then it is admitted by the court that the authorities are divided. In reaching its conclusion, the court says that the bank was innocent third party.

Such, however, is not the fact in the instant case because here the bank was not a third party, but a party in direct privity and contractual relationship with its

depositor and was not innocent but guilty of a breach of its *positive* duty, whether it did so carelessly, knowingly, or otherwise. Liability is not based upon mere negligence but upon breach of this positive duty. In truth and in fact the defendant bank did not—and the evidence showed the custom of the banks—inquire or seek authentication of the genuineness of the payee's endorsement in compliance with its duty, but was satisfied to rely upon the conduct and guaranty of the indorsers subsequent to the payee to perform this duty. It may well be said that it delegated this duty—an absolute and positive duty imposed upon it and owing to its depositor—to said indorsers and hence the negligence of such persons in failing to authenticate the payee's indorsement is imputed to it. Or, without resorting to legal fiction, it saw fit to omit performing this duty and to rely solely upon the absolute guaranty of the indorsements of the collecting banks.

In addition to the cases heretofore cited in this portion of our argument as supporting appellant's right to recover under the principle of subrogation, we cite the following cases:

Fidelity & Deposit Co. v. Oklahoma State Bank, 77 F. (2d) 734. (C.C.A. 10th) (The opinion is written by Circuit Judge Lewis, who wrote the opinion in *American Surety Co. v. Citizen's National Bank, supra.*) The plaintiff in that case as the insurers in the instant

case agreed to indemnify the employee's employers for defalcations. The bank was not guilty of any "culpable" negligence nor was it a drawee which breached its positive duty, but was merely negligent.

National Surety Co. v. Bankers Trust Co., 210 Ia. 323, 228 N. W. 635.

Metropolitan Casualty Ins. Co. v. First Nat'l Bank of Detroit, 261 Mich. 450, 246 N. W. 178.

Fidelity & Deposit Co. of Md. v. Fort Worth Natl. Bank (Com. of Appeals, Tex.) 65 S. W. (2d) 276.

Rivers vs. Liberty Natl. Bank, 135 S. C. 107, 133 S. E. 210.

Maryland Casualty Co. v. Chase Natl. Bank, 153 Misc. 538, 275 N. Y. S. 311.

First & Tri-State Nat. B. & T. Co. vs. Mass. Bonding & Ins. Co., 102 Ind. A. 361, 200 N. E. 449.

This last case is of special interest because it involved an action by the insurance company for the drawee bank against a collecting bank. In view of the contention of the "equities" of the parties, this case suggests a clear answer. The appellants have made the payment and therefore suffered a loss which they seek to recover from the appellee, Bank of California. The bank's contention of "equities" conveys the idea that if it pays this loss, which under the law it should, it will suffer the loss, and

since it was not an active participant in the fraud and received no benefit from the transactions (which view is erroneous in itself, because as a bank it does receive a benefit from the handling of its depositors' funds) the "equities" are with it as against the appellants who received premium payments. The fact of the matter is that the appellee in this case will not sustain any loss, because it can recover from those to whom the checks were presented by the forger, or from the First National Bank of Portland and the United States National Bank, the amount of these checks, because the checks came to the appellee through these banks, and others who guaranteed the indorsements. The defendant, or its surety, can do what the plaintiff in the above case, *First Tri-State Nat. B. & T. Co. vs. Mass. Bonding & Ins. Co., supra,* did. Hence, "equities" are not in favor of the appellee. Following this procedure of recovery over, which exists under recognized legal principles of law, and which under the Rules of Civil Procedure could and should have been followed in the instant case, the loss will be placed upon the parties who dealt with the forger, and who were careless and negligent in securing proper identification of the named payees, and thus are devoid of these socalled "equities."

To deny the appellants the right of subrogation in this case would be going backwards in the law. The learned trial court in his opinion (Tr. 89), recognized

that Interior Warehouse Company could recover from the bank, but denied appellants this right under subrogation. In *Grubnau vs. Centennial Natl. Bank, supra,* in which a recovery was allowed to the insurance company, the inconsistency of such a stand is pointed out when the court states that the insurance company need not compel the insured to first sue the bank and pay the insured only if the latter suffers a loss by failing to collect from the bank. But the result of the decision in the instant case will lead to this.

How inconsistent such procedure is with the spirit of the attempted judicial reforms as exemplified by the new Rules of Civil Procedure. The movement has begun to expedite the settlement of controversies, to eliminate repeated litigation and to speed up the processes of the courts to the business tempo of the country. And yet the result of this case is a direct step in the opposite direction. The learned trial judge remarked that the case should be viewed realistically (Tr. 89, 347). So should the result of his decision. If this decision is allowed to stand as the law in this type of case, it is apparent what insurance companies will do. Instead of writing policies such as they did in this case and paying the loss upon its discovery and demand by the insured, the policies will be so written that the insured must first seek recovery from the bank and only after the assured

litigates (or by subterfuge or terms of the policy the insurance companies will handle such litigation for the assured) will payments be made. Such is not progress in the law, and in practice should not be encouraged by judicial decisions.

As long as the insured could recover there is no reason to deny subrogation to the insurance company. All the defenses which the bank has against its depositor can and has been asserted against the insurance companies and the doing of equity does not require more.

Closely connected with the above observations of the realities is the consideration of the fact that in writing insurance policies, insurance companies do bear in mind the value of subrogation as an incident to the policies. Attention need only be called to the numerous cases in the reports dealing with subrogated claims by insurance companies. Without this right, premiums would of necessity be much higher and certain policies would in fact not be written. This fact is likewise recognized in that excellent opinion in *Martin et al vs. Federal Surety Co., supra* (58 F. (2d) 79) at p. 90:

> "While the record does not show anything as to rates being made in consideration of the right of subrogation, it is reasonable to believe that the fact of subrogation would affect the rates paid for the indemnity. Appellee paid the liability immediately, and it seems to us the equities of this situation are with appellee."

As a final citation of authority for the right of plaintiffs to be subrogated to the cause of action which the depositor had against the appellee, plaintiffs cite the Oregon case of *U. S. Fidelity Co. vs. United States Nat. Bank,* 80 Or. 361, 157 P. 155. Under the authority of this case, there is no question of the surety's right to recover by subrogation. In that case the insured, or principal in the bond, was himself guilty of wrong and yet the Oregon Supreme Court permitted the surety to recover under the principle of subrogation, because it paid an obligee. (Appellants' assured in the instant case did not commit a wrong and appellants paid their assured.) The bank was not guilty of "culpable" negligence but breached its agreement as a depository and the court said, page 368:

> "The bank by its wrongful act (breach of its contract) in paying out the funds on the private checks of another, made it possible for the other to squander the money of the wards, and thus became in effect a joint tort-feasor liable for the defalcation."

The same is true of the instant case and the rule of the Oregon Supreme Court should be applied. In doing so, we are not asking this Court to do violence to any of the established principles of law, but rather seek their application.

OPINION OF TRIAL COURT

The trial court's opinion is set forth in the Transcript of Record beginning at page 67. The argument heretofore made shows that the trial judge arrived at his decision by an erroneous application of the law to the facts in the instant case. However, we wish here to briefly point out the reasoning of the trial judge as disclosed in his opinion and thus show wherein he erred.

In his opinion (Tr. 77) he recognizes that courts of many jurisdictions, which are entitled to the highest respect have permitted an insurance company to recover from a bank in cases similar to the instant case. He further states (Tr. 77) that:

> ". . . The controlling factors in these decisions are, usually, the rule that the bank is absolutely liable wherever it pays out money on a forged endorsement of the payee, and, secondly, the alleged principle that a surety is entitled to all the remedies which 'the creditor would have against all persons liable for the debt'."

This, we submit again, is the law and appellants are entitled to have it applied to them.

The Honorable Trial Court then states (Tr. 78):

> "These decisions neglect consideration of the fact that the forger is the only wrongdoer in the situation. Likewise, they neglect consideration of the highly equitable nature of subrogation."

We submit that this is an erroneous conclusion of the facts and law and it therefore is an erroneous premise on which to decide the case. Coupled with said erroneous conclusion is the trail judge's statement and view which he repeatedly expresses throughout his opinion that the bank was not guilty of negligence, that it was not a wrongdoer and that it was an innocent party (Tr. 77, 88, 89). The trial court is also in error when he states that (Tr. 86):

> ". . . The dishonesty of Crowe was the sole cause of the loss sustained by anyone. If it had not been for that factor, no loss would have occurred."

The Oregon case of *United States Fidelity Co. vs. United States Nat. Bank, supra* (80 Or.361, 157 P.155), discussed and quoted from by the trial judge in his opinion (Tr. 78) shows that his views as above set forth are erroneous and also that he did not follow the law of Oregon as declared by the Supreme Court of the state, which law the Federal courts must follow.

In that case the *principal* on the bond was dishonest and committed fraud. The surety in that case *did* make itself primarily responsible for its principal's defalcations and it did not pay an *assured* but an obligee. The bank committed no "wrongful" act other than a breach of its contract with its depositor—the same implied contract arising from its acceptance of its depositor's funds as involved in the instant case.

In permitting the surety to recover from the bank by being subrogated to the estate to which it paid the amount of its principal's defalcations, the Oregon Supreme Court made the statement set forth in the trial court's opinion (Tr. 78).

That statement applies with full force to the instant case. What does the Oregon court mean by "its wrongful act"? Nowhere in its opinion does the Oregon court indicate that it is speaking of a "wilful act," a "fraudulent act," an act whereby the bank "knowingly abetted" the dishonest guardian, or of being guilty of "culpable" negligence. The only wrongful act with which the Oregon court is dealing is the act of the bank in breaching its agreement. Yet such an act it states is "wrongful"; that it made it possible for the guardian to squander the money of the ward and that thereby the bank became in effect a joint tort-feasor.

The Oregon court did not view the dishonest act of the guardian as the "sole cause" of the loss, nor did it view the dishonest guardian, the principal on the bond, as the "sole wrongdoer," and that "if it had not been for that factor, no loss would have occurred" (Op. Tr. 87).

Of course a payment of a check bearing a forged indorsement cannot occur without the initial dishonest act of the forger. But such act of the forger is not the

sole cause of the loss. *The loss can only occur by payment by the bank on which it is drawn,* by breach of its duty by paying same or in its willingness to accept the guaranty of subsequent indorsers as a fulfillment of its obligation to pay checks only on the order of the drawer. The act of the bank or the person to whom the check is first presented and cashed is the proximate cause and that person's negligence in not securing proper identification from the forger must be viewed as being transmitted to the bank by reason of the bank's reliance on the subsequent indorsements. A forger can forge payee's names to checks all day long and his act in doing so without payment by the bank will not result in a loss.

The Oregon case of *American Central Insurance Co. vs. Weller,* 106 Or. 494, 212 P. 803, in no way altered or weakened the rule laid down in *United States Fidelity Co. vs. United States Nat. Bank. supra* (80 Or. 361, 157 P. 155). It reaffirmed the law of that case, and the law we claim is applicable, in its statement quoted by the learned trial judge in his opinion (Tr., p. 79), and as indicated by the emphasis supplied. The appellants in the instant case seek to be subrogated to the right of action which their insured had against the bank "whose wrongful act or neglect caused the loss."

In the Weller case, the defendant Weller himself,

obtained the policy of insurance and paid the premium. He assigned the contract of sale covering the automobile to the bank. Had he not assigned the contract the loss would have been paid directly to him under the policy. He himself was in the position of an insured. Furthermore, as stated by the court:

> ". . . Weller was in no way responsible for the loss or conversion of the car. He is not accused of any wrongful act."

The facts of the case are so different that a mere reading of the opinion makes it clear that the Oregon court was not limiting the rule of *United States Fidelity Co. vs. United States Nat. Bank, supra.* The Oregon court cites and discusses in its opinion the case of *Chicago, etc. R. Co. vs. Pullman,* 139 U. S. 79, 11 S. C. 490, 35 L. Ed. 97. The law of this case, which the Oregon Supreme Court recognizes in the Weller case as being correct, is applicable to the instant case. We call this Court's attention to the quotation, in the opinion, from that case. The liability of the appellee bank to the Interior Warehouse Company by reason of their contract relationship is similar to the liability of the railroad company to the Pullman company discussed by the court.

In view of these Oregon decisions, we submit that the trial judge failed to follow the Oregon law as declared by the Oregon Supreme Court.

In view of the facts of the instant case and the law which grants to the insurance companies by subrogation the rights of the insured as against third persons liable to the insured, recognized as the law of Oregon as declared in the above mentioned Oregon cases, the remainder of the trial court's opinion dealing with election of remedies and the primary obligation of the insurers is erroneous and has no application to the instant case.

If the acceptance by an insured of payment of a loss payable to it by an insurance company constituted an election of remedies then there never could be a case whereby an insurance company was subrogated to the rights of its insured. The very case of *Chicago, etc. R. Co. vs. Pullman, supra,* discussed by the Oregon Supreme Court in the Weller case is a direct refutation of an election of remedies in this case. As stated in that opinion (see quotation in the Weller case):

> "The collection of the insurance money did not . . . impair the right of the (Pullman) Company to recover the amount of the loss according to the contract with the railroad company. Upon payment of the loss, or to the extent of any payment by them on account of the loss, the insurance companies were subrogated to the rights of the insured and could in its name, or in their joint names, maintain an action against the railroad company for indemnity, if the latter was liable to the insured for the loss of the cars;"

(It is also significant in the above case that this right of recovery over is not made dependent upon "fraud," "culpable negligence" or "wrongdoing" in any sense other than legal wrong which includes "breach of contract." The liability of the railroad company which was required to pay the insurance company was based upon its contract with the Pullman Company.)

An election of remedies does occur when the insured, or its insurance company subrogated to it, prior to its action against a given party has pursued its right of recovery against another also responsible to it. Such a case is *National Surety Co. vs. Perth Amboy Trust Co.* (C.C.A. 5), 76 F. (2d) 87.

The above observations also show the erroneous view of the trial court in its statement (Tr. 87):

> ". . . One should not be entitled to recover from another that which he has paid out in discharging a debt in the performance of his own obligation."

Such statement when applied to a payment by an insurance company under its contract of insurance ignores the whole principle of subrogation concededly granted to an insurance company, because in every case its payment is made pursuant to an obligation. In fact, unless its payment is made pursuant to an obligation it cannot

be subrogated, because it would be a mere volunteer and as such not entitled to subrogation.

This erroneous view of the trial court likewise persists in the statement that "Interior is not entitled to more than one recovery." Interior in no way obtains another recovery. Such argument if permitted would not only deny subrogation, but would entirely eliminate it as a principle of our law, because the very nature and meaning of subrogation is that the person subrogated *recovers under the right of the subrogee who has already been paid.* And furthermore, the law does not permit the subrogee to retain the recovery, even if he himself brings the action in his own name.

Comment is also felt necessary on the remarks of the trial judge (Tr. 88) that "If recovery is permitted against the bank the situation will be prolific of litigation." He then recognizes that appellee can sue the collecting banks and these can sue other primary indorsers subsequent to the forged indorsement. Is this judicial reasoning justifying a denial of subrogation? Prolific litigation cannot be an excuse and in fact is or was not necessary. Again we call this court's attention to the new Federal Rules of Civil Procedure, Rule 14 (a), under which appellee could and should have brought in these persons who were liable to it under

their indorsements. (See collection of authorities in recent case, *John N. Price & Sons vs. Md. Casualty Co.*, 2 F.R.D. 409, 410.) We also call this court's attention to the fact that this was called to the trial court's attention at the trial (Tr., pp. 344-347). Any reason for prolific litigation, and the failure of these indorsers to have been brought in is due to the failure of appellee to implead them. In view of this appellants should not be prejudiced and denied the right of subrogation. They are not at fault.

At this point in his opinion and in other places the learned trial judge remarks that it is more reasonable to allow the loss to remain upon the insurance companies who receive a premium for their obligation. We shall not present arguments on this question as to whether it is more reasonable to have the loss fall upon the insurance company and deny it the right to be subrogated to the rights of the insured. The law as declared by the courts throughout the country, including the Oregon Supreme Court, is that the third party responsible and legally liable gets no benefit from the insurance purchased by another. Until the law is changed insurance companies can by reason of subrogation recover from third persons liable to the insured. Appellants are entitled to the law as it now exists and as it has been declared by the Oregon Supreme Court and under said

law appellants are entitled to a judgment against appellee. The judgment of the trial court is erroneous and it is respectfully submitted that it should be reversed and judgment should be entered for appellants.

Respectfully submitted,

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APPENDIX "A"

The principles governing the bank's liability is excellently and clearly discussed in several leading cases cited in our brief dealing with transactions almost identical with those in the instant case. The opinions, however, are long and the cases should be read in full, rather than digests therefrom. However, a clear and complete statement of these principles of law is to be found in Zollman, Banks & Banking, Vol. 6, sections 4231, 4232, 4233. This authority is perhaps the best on the subject, and the text is very ably annotated. The following is that author's statement of the law:

> "Sec. 4231. Drawee Bank's Duty to Drawer to Determine Whether Payee's Signature Is Genuine or Authorized.
>
> "The drawee bank at its peril must identify the payee of an order instrument (2). * * *
>
> "A check or draft properly (7) drawn to order is not payable at all until properly indorsed by the payee or his duly authorized agent (8).
>
> "The drawer has a right to insist that the drawee pay his checks only on his order (9).
>
> "The drawer does not owe the duty to the drawee so to prepare its checks that they cannot be successfully tampered with or to employ only honest clerks (10).
>
> "The drawee bank, though it is not chargeable with knowledge of the genuineness of the signatures of the indorsers in the sense in which it must know the signature of the drawer (11), owes the depositor

the absolute duty to pay it only as directed (12) to the person or persons designated by the drawer (13), and, in the absence of estoppel (14) or negligence (15), which is the proximate cause of the loss (16), and which must be proved by the bank (17). * * *

"Its action is not payment so far as the depositor is concerned (23). The impossibility of detecting the forgery is a risk assumed by it (24). It has no right to charge his account with the check so paid (25), and must bear the loss (26).

"Where the only authority given by the customer to the bank is to pay the check on the order of the payee, it is bound to ascertain the genuineness of such payee's signature (28), whether payment is made through the clearing house or over the counter (29).

"The customer, by drawing the check, imposes this duty on the bank (30), and even negligence on his part is unknowingly making it payable to a fictitious or non-existing person (31) or in delivering it to a person other than the payee (32), or to the wrong employee (33), * * * or in failing to keep books (37), or in failing to keep its books in the most painstaking manner (38), or in failing to discover the forged indorsement (39), is no defense.

"The fact that the drawer has tossed the check at a spittoon without destroying it before executing a duplicate (40), or has made checks payable to its members on forged applications for withdrawals, the means of verifying the signature of such members being at hand (41), has therefore been held to be immaterial.

"In paying checks to any other person than the one to whom they are made payable, the bank therefore acts at its peril (42). It is bound to ascertain the genuineness of the endorsement (43) and, where the payee or endorsee is unknown to it, may require him to identify himself (44).

"The fact that it pays the instrument on the guaranty of another bank does not affect its duty toward its depositor (45). It may not assume that its customer has authority to endorse the payee's name to the check (46).

"The genuine endorsement of the bank from which the drawee has received the check is no defense as against the drawer (49).

"The customer, in the absence of actual knowledge, may assume, when the check is returned to him as a cancelled voucher, that the bank has performed its duty (50). He is not required to know the signature of payees on returned vouchers (51). He need not, in the absence of suspicious circumstances, search through the cancelled checks for forged indorsements (53).

"His receipt of and acquiescence in the cancelled check does not guarantee the endorsement on it and does nothing more than recognize the direction to the drawee to pay to the order *of the payee* (54).

"The payment by the bank of the check is an assurance to him that the bank has assured itself of the genuineness of the preceding indorsements (55). He is certainly not as much bound as is the drawee to know that the first of several indorsements is forged (56).

"Even if he has the means to verify the signature of the payee, such verification is an act in excess of the duty which he owes to the bank (57). * * *

"Sec. 4232. Bank Paying Check on Forged Indorsement Pays Its Own Funds.

"A payment on a forged indorsement is not a payment in accordance with the drawer's directions (60). The drawee bank therefore pays the check at its peril (61).

"If the indorsement is genuine, it is a payment

out of the depositor's funds. If it is forged, it is a payment out of the bank's own funds (62), which the bank is not justified in charging against the account of the drawer (63), in the absence of some element of estoppel (64). * * *

"Evidence, therefore, of payment by the bank on a forged indorsement establishes the liability of the drawee toward the drawer (74).

"The fact that fraud is practiced in obtaining from the drawer a genuine check in favor of a third person does not relieve the drawee bank from liability for paying such check on a forged indorsement (75).

"Sec. 4233. Drawer's Liability to Drawee for His Agent's Forgery of Payee's Indorsement.

"The mere fact that an agent of the drawer forges the payee's signature does not improve the position of the drawee bank. The drawer is not bound by such payment where the indorsement is a forgery (76).

"A depositor need not personally handle his checks, but may employ subordinates and rely implicitly on their honesty and integrity, and it is not responsible for their act in forging indorsements of the names of the payees on checks drawn by him (77). * * *

"The hazard of ascertaining the authority of the person who asserts the right to indorse a check is imposed on the drawee, in the absence of estoppel of the drawer (81).

"To be estopped by the act of the agent, the drawer must have had sufficient knowledge of his unfaithfulness (82).

"The mere fact that he has drawn the check on the agent's fraudulent statement that he (the drawer) is indebted to the payee will not be sufficient to operate as an estoppel (83). That he has sent the check to his fraudulent agent is not proof of negligence (84).

APPENDIX "B"

Quotation from 9 C.J.S. at p. 740, cited in Brief, p. ——:

"Where a check is knowingly drawn to the order of a fictitious or non-existing person, it is payable to bearer, as is shown in the title Bills and Notes, Section 192, 8 C. J., p. 339, note 20. The bank is under no duty to ascertain the genuineness of the indorsement of the payee (26), and thi is true, also, where such a check is drawn by an authorized agent (27).

"The fictitiousness, in this respect, however, does not depend on the identification of the name of the payee with some existent person, but on the intention underlying the act of the maker in inserting the name (28). Accordingly, if the drawer is not aware that the payee is a fictitious or non-existing person, the previously considered rule, requiring the bank to determine the genuineness of the indorsement at its peril, applies to the indorsement of such a check (29), irrespective of the provision of the Negotiable Instruments Law to the effect that the drawer admits the existence of the payee and his then capacity to indorse (30). *So, if the drawer is induced by the fraud of a third person, or by that of his own agent, to draw a check to a fictitious person, believing in good faith that such payee is a real person, the bank will not discharge any of its indebtedness to the drawer by paying such a check on a forged indorsement* (31), *and will render itself liable to the drawer for charging his account therewith* (32), unless the payment was made on the basis of the drawer's representations (33), or was made to the person actually *intended by the drawer* (34). *Conversely, the bank cannot recover of the drawer for the payment of such a check although forged by the drawer's agent* (35). The drawer's negligence in such situation is immaterial, unless it directly and proximately affects the conduct of the bank in paying the check (36)." (Emphasis ours.)

APPENDIX "C"

Quotation from case of *Shipman et al vs. Bank of State of New York,* 126 N. Y. 318, 27 N. E. 371, referred to in Brief, p. ——:

"It is claimed by the defendant that the checks made payable to the order of persons having no existence were, in legal effect, payable to the bearer. It is provided by statute that paper made payable to the order of a fictitious person, and negotiated by the maker, has the same validity, 'as against the maker and all persons having knowledge of the facts, as if payable to bearer'. 1 Rev. St., p. 768, No. 5. We are of the opinion, upon examination of the authorities cited by counsel on both sides, that this rule applies only to paper put into circulation by the maker with knowledge that the name of the payee does not represent a real person. The maker's intention is the controlling consideration which determines the character of such paper. It cannot be treated as payable to bearer, unless the maker knows the payee to be fictitious, and actually intends to make the paper payable to a fictitious person. Bank vs. Alley, 79 N. Y. 536; Turnbull vs. Bowyer, 40 N. Y. 456; Vagliano vs. Bank of England, 22 Q. B. Div. 103, on appeal, 23 Q. B. Div. 243; Armstrong vs. Bank, 22 N. E. Rep. 866 (Sup. Ct. Ohio, Oct. 1889); Gibson vs. Minet, I. H. Bl. 569. The findings of the referee that the plaintiffs in good faith believed that the names of the payees represented real persons, entitled to receive from them the amount of the check in each case, having been led to believe this by the fraudulent contrivances of Bedell, and that they intended that Bedell should deliver the check to a real payee therein named, and that they did not intend that they should go into circulation or be paid by defendant otherwise than through a delivery to and indorsement by the payee named, and that plaintiffs

the payee, or to put the checks into circulation, and that no one in fact relied on any appearance of authority, derived from the plaintiffs, in Bedell to indorse the payee's name upon the checks, or to put them in circulation, disposes of this question. The indorsement of the names of the fictitious payees upon the checks in circulation, constituted the crime of forgery, by means of which, and without any fault of the plaintiffs, payment was obtained thereon. The defendant does not occupy any different position with reference to the checks payable to fictitious payees than it does with reference to those payable to real parties whose indorsements were forged. Bedell of course knew that the payees were fictitious, but he was not acting within the scope of his employment, but in carrying out a scheme of fraud upon the plaintiffs, and under such circumstances his knowledge cannot be imputed to his principals. Frank vs. Bank, supra; Weisser vs. Denison, supra; Welsh vs. Bank, supra; Cave vs. Cave, 15 Ch. Div. 643, 644."

APPENDIX "D"

Quotation from case of *American Sash & Door Company vs. Commerce Trust Co.,* 332 Mo. 98, 56 S. W. (2d) 1034, referred to in Brief, p. ——:

"The second defense urged by the trust company is that the fifty checks were in law payable to bearer because they were made out to fictitious payees, that is to say, to one non-existent person and six former employees who were not entitled to them or intended by Tschupp to receive them. For this reason it is contended the defendant bank had a right to cash the checks regardless of the indorsements, and is therefore not liable. This is the point on which we think the trial court decided the case." * * * "When, however, the agent or employee has no such authority

and does not execute the checks, but merely fraudulently induces his principal to issue them to others in good faith, the rule is otherwise, and the maker is not bound by the guilty knowledge of his employee. This distinction is expressly drawn in Phillips vs. Mercantile Nat'l Bank, supra, cited by respondent, and is further pointed out or made apparent in the following decisions, in all of which the facts are closely parallel to those of the case at bar: (Citations of cases omitted.)

"The further contention is made by the defendant trust company in the present case that since Tschupp was authorized to make up the payroll, therefore, when he made a false payroll he was acting in the scope of his authority and in line with the reasoning of the above decisions bound the plaintiff by his guilty knowledge and intent. But that is another matter. The padding of the payroll was not the proximate cause of the *cashing* of the checks indorsed as they were. In determining whether the checks were payable to bearer under our statute, we are not concerned with Tschupp's authority in the company's other activities, but solely with his agential powers in the execution of checks; and as to that he had none.

"Can it be the law that where a company has hundreds of employees severally engaged in its multiform activities, specific knowledge possessed by any one of them within the scope of his particular employment will be imputed to the company throughout the entire field of its operations and as affecting disconnected matters in charge of other employees not similarly advised? In answer it may be said making up a payroll is not disconnected but closely related to the matter of paying the wages called for thereby. But they are different functions and different in their causal affect, as this case illustrates. Authority is often divided in such concerns, one set of employees or officers making up requisitions and another scrutinizing and paying them for the very purpose of preventing frauds." * * *